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IN THREE SECTIONS

Section I

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IN THIS ISSUE

Further Consideration of the Last-in, First-out Basis of Inventory Valuation,

by George A. Wilson..... 1

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EDITORIAL DEPARTMENT NOTE

In passing the Revenue Act of 1939 at the session which closed recently, Congress extended the privilege of using the last-in, first-out method of inventory valuation to all taxpayers who satisfy the conditions prescribed in the statute. Previously, tanners and producers and processors of nonferrous metals had been the only groups permitted to use this method. Several articles dealing with this method of inventory valuation have appeared in the *N. A. C. A. Bulletin*. In general, they have dealt with the advantages of the last-in, first-out method for those industries where it is applicable. In the light of the current interest in the subject flowing from the provisions of the new tax law, it is felt that the article in this issue, pointing as it does to some possible disadvantages in the use of this method, will be of considerable interest to N. A. C. A. members.

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SEPTEMBER 1, 1939

FURTHER CONSIDERATION OF THE LAST-IN, FIRST-OUT BASIS OF INVENTORY ACCOUNTING

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A CAREFUL consideration of the commercial activities of almost any business usually leads to the conclusion that the profits or losses can best be judged by viewing the operating results over a term of years or a business cycle, including years of low prices and curtailed production, and years of high prices and expansion. Nevertheless, stockholders, management and our lawmakers are not content to wait for the end of a cycle to learn how a business has prospered. Why the period of a year of twelve months has been adopted for measuring the current progress of business is unimportant. Perhaps the twelve-month period grew like Topsy, but it seems here to stay with us for several generations anyway, and therefore business must conform, for the present at least.

In most commercial activities, annual inventories or reliable perpetual inventories subject to verification throughout the year are necessary if operating results are to be even approximated. The old cost-or-market basis of inventory accounting has, on the whole, served business well, although it must be admitted that that basis may not be logical in all cases. As in some instances the cost-or-market basis has proved confusing and perhaps illogical, other methods of inventory valuation, such as the base stock method and the last-in, first-out basis, have received the attention of business. The principal feature of both of these latter bases of inventory valuation is that they tend to prevent the reporting of so-called "inventory profits" on a rising market. Under the base stock method, which assumes practically a constant inventory quantity, the inventory will always be valued lower than actual cost or current market price, unless it should happen that current market price is lower than the low price which prevailed at the time the basis was adopted. In theory, the last-in, first-out basis is somewhat similar, but in actual practice it is possible for the last-in, first-out basis to result in a valuation in excess of cost or current market, due to the fact that such basis is seriously affected by variations in inventory quantities from year to year.

The base stock method has been satisfactorily used by the National Lead Company and others for a number of years, but its further development probably will be slow because of the rejection of that method by the United States courts for income tax purposes. The last-in, first-out basis, being somewhat similar to the base stock method, naturally has aroused considerable enthusiasm, because in the Revenue Act of 1938, the use of the last-in, first-out basis of inventory accounting for income tax purposes was granted to producers and processors of certain nonferrous metals and to tanners, upon their election to adopt it, and as a result other industries have been considering the adoption of this basis.*

In connection with the use of the last-in, first-out basis, as provided in Section 22 of the Revenue Act of 1938, it should be borne in mind that all inventory computations must be based upon cost, and that no adjustments to market value at the end of a fiscal year are permitted. Below is an excerpt from Article 22(d)-1 of Regulations 101, issued by the U. S. Treasury Department, explaining the method of inventory valuation under Section 22 of the 1938 Revenue Act:

> "Regulation Art. 22(d)-1. Inventories of tanners, and producers and processors of certain nonferrous metals.—(a) Elective method.—The general rule is that goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently acquired which cannot be so identified. An exception to this general rule is provided for in Section 22(d), which permits certain specifically described taxpayers to elect to treat certain raw materials remaining on hand at the close of the taxable year as being: first, those included in the inventory as of the beginning of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year, in the order of acquisition. No item in an inventory of raw materials to which this method is applied shall be valued at market. All inventories of such raw materials (including the inventory as of the

* Since this article was written, the Revenue Act of 1939 has been passed, extending the privilege of using the last-in, first-out basis to all taxpayers who satisfy the conditions prescribed by the statute, for taxable years beginning December 31, 1938.

close of the preceding taxable year) shall be taken at cost. The opening inventory of such raw materials for the taxable year for which an election is made shall be brought in at the same cost as the closing inventory of such raw materials for the preceding taxable year. . . . ."

This paper is not intended as an attempt to discredit the last-in, first-out basis, but merely to call attention to the fact that this basis may not always produce the results hoped for. Perhaps too much attention has been given to the theoretical principles involved, and not enough attention has been given to the practical side by advocates of the basis.

Outline of the Last-In, First-Out Basis

Careful study of the subject by those who favor the last-in, first-out basis has led to the conclusion that it should be adopted only by industries in which the following conditions exist:

(a) Raw materials (including those in process and in finished goods) are so intermingled that they cannot be identified with specific invoices.
(b) There are violent fluctuations in the cost of raw materials.
(c) The market prices of finished products follow closely the market prices of raw materials.
(d) The quantity of inventory is fairly constant from year to year.
(e) There is no style element involved in the finished goods.

The principal advantages claimed for the last-in, first-out basis of inventory accounting are summarized below:

1. The basis minimizes the reporting of so-called "inventory profits" (profits which have not been reduced to cash or receivables) during a period of rising prices.
2. The basis results in showing costs of sales, based upon cost of materials purchased during the year, and not distorted by inventory reductions to market values at the end of the year.
3. The basis results in showing more stabilized profits over a term of years than the cost-or-market basis.

Under the cost-or-market basis of inventory accounting it is usually assumed that the inventory on hand at the end of the year is represented by the most recently purchased items; consequently, on a rising market, the same quantity of inventory on hand at the end of the year as was on hand at the beginning of the year will be valued higher than at the beginning of the year. It is therefore obvious that on the cost-or-market basis the profits for a year, on a rising market, might have been reinvested in inventories, but such reinvested profits may be lost if the market later declines. For example, assume (1) that a manufacturer had on hand at the beginning of the year 1,000,000 pounds of a commodity valued at 10¢ per pound and aggregating $100,000; (2) that his profits amounted to $10,000 for the year on the cost-or-market basis of inventory accounting; and (3) that he had an inventory of 1,000,000 pounds at the end of the year at a cost-or-market value, whichever lower, of 11¢ per pound, aggregating $110,000. From this example it would appear that the profit of $10,000 made by the manufacturer has been reinvested at the end of the year, for the quantities are the same at the beginning and end of the year, but the value of the closing inventory is $10,000 greater than the value of the inventory at the beginning of the year. Obviously, should the closing inventory later decline to 10¢ per pound, the "profit" of $10,000 which he apparently had made during the past year, based upon the cost or market basis, would be wiped out by the shrinkage of $10,000 in the current year.

Under the last-in, first-out basis, the inventory at the end of the year is valued at the same price that existed at the beginning of the year, provided the closing inventory does not exceed *in quantity* the inventory at the beginning of the year. Should the inventory at the end of the year exceed *in quantity* the inventory at the beginning of the year, then the closing inventory would be valued at the same price that existed at the beginning of the year for the same quantity of inventory that was on hand at the beginning of the year, while the quantity at the end of the year in excess of the quantity at the beginning of the year would be valued at the cost of the earliest purchases during the year, in the order of acquisition. Market value at the end of a year is not taken into consideration in the last-in, first-out basis, but on a rising market, inventories on that basis will always be shown at a value lower than

that which would be shown by the cost-or-market basis. Inventories on the last-in, first-out basis will usually be shown on a declining market, at a value lower than that which would be shown by the cost-or-market basis, assuming the market was at a very low point when the former basis was adopted.

With regard to the principal advantages claimed for the last-in, first-out basis, it must on the one hand be admitted (1) that if the basis is adopted when market values are low, the basis will tend to minimize "inventory profits" on a rising market, and (2) that cost of materials consumed during a year on the last-in, first-out basis follows closely the cost of materials purchased during the year. However, it should be borne in mind that over a business cycle, profits ought to aggregate about the same on both the last-in, first-out and the cost-or-market bases; consequently, if profits are reduced on a rising market under the last-in, first-out basis, profits necessarily will be increased on a declining market. On the other hand, it cannot be admitted that, in all cases, profits over a cycle will be more stable on the last-in, first-out basis than on the cost-or-market basis. Furthermore, it would seem that the minimizing of "inventory profits" on a rising market and any stabilizing of profits over a cycle can be accomplished under the last-in, first-out basis only by grossly understating the true values of inventories at the end of certain years when compared with inventories on the cost-or-market basis.

Under the next two captions of this paper there are presented, respectively: (1) hypothetical examples of the last-in, first-out basis compared with the cost-or-market basis, under varying conditions, and (2) a comparison of the last-in, first-out basis with the cost-or-market basis, in an actual case.

Hypothetical Examples of Last-In, First-Out Basis Compared With Cost-or-Market Basis Under Varying Conditions

In order to more clearly set forth the effect upon operating results, under the cost-or-market basis and under the last-in, first-out basis, of variations in the quantities of inventories from year to year and of fluctuations in raw material prices, there are shown at the end of this article three statements (Schedules A, B and C)

indicating respectively, comparisons between hypothetical inventories, purchases and cost of materials consumed (1) on the cost-or-market basis and (2) on the last-in, first-out basis, assuming three different conditions in the raw materials market during a year, viz.: a steady market during the year, a rising market during the year and a declining market during the year. Schedule A assumes the same quantity of inventory at the beginning and the end of each year; Schedule B assumes a reduction of the quantity of the inventory at the end of the year when compared with the quantity at the beginning of the year; Schedule C assumes an increase in the quantity of inventory at the end of the year when compared with the quantity at the beginning of the year. Inasmuch as some branches of the cotton industry have exhibited interest in the last-in, first-out basis, the hypothetical examples herein have been treated as applying to the cotton textile industry.

Below the pertinent facts set forth in Schedules A, B and C are summarized:

	Inventory on Last-In, First-Out Basis over (+) or under (—) Inventory on Cost-or-Market Basis	Increase (+) or Decrease (—) in Profit for year on Last-In, First-Out Basis when compared with Cost-or-Market Basis
Steady Cotton Market		
Same quantity of inventory at beginning and end of year.....	—$ 20,000.00	—$ 20,000.00
Reduction in quantity of inventory during year	—$ 10,000.00	—$ 10,000.00
Increase in quantity of inventory during year	—$ 20,000.00	—$ 20,000.00
Rising Cotton Market		
Same quantity of inventory at beginning and end of year.....	—$120,000.00	—$120,000.00
Reduction in quantity of inventory during year	—$ 60,000.00	—$ 60,000.00
Increase in quantity of inventory during year	—$120,000.00	—$120,000.00
Declining Cotton Market		
Same quantity of inventory at beginning and end of year.....	+$ 60,000.00	+$ 60,000.00
Reduction in quantity of inventory during year	+$ 30,000.00	+$ 30,000.00
Increase in quantity of inventory during year	+$ 60,000.00	+$ 60,000.00

Upon further reference to Schedules A, B and C it may be seen that in comparing the valuation of inventories upon the last-in, first-out basis with inventories on the cost-or-market basis, the fluctuations range from an undervaluation of $120,000, or 33⅓ per cent, on a rising market (when compared with the cost-or market basis) to an overvaluation of $60,000 or 33⅓ per cent, on a declining market. Although such variations may appear large, it should be borne in mind that the range of cotton prices and the fluctuations in quantities between the beginning and end of the year used in Schedules A, B and C are typical of the cotton industry.

In Schedule D, another statement is presented showing a comparison between inventories, purchases and cost of cotton consumed during a period of seven years, on the cost-or-market basis and on the last-in, first-out basis, assuming hypothetical quantities of cotton on hand at beginning and end of each year and hypothetical purchases of cotton, but following, as to cotton prices for the first six years, the approximate conditions which existed in the spot cotton market during the years 1933 to 1938, inclusive. The pertinent facts set forth in Schedule D are summarized below:

	Inventory at end of year on Last-In, First-Out Basis over (+) or under (—) Inventory on Cost-or-Market Basis	Increase (+) or Decrease (—) in profit for year on Last-In, First-Out Basis when compared with Cost-or-Market Basis
1st year—1933 (rising market)	—$ 75,000.00	—$ 75,000.00
2nd year—1934 (rising market)	—$165,000.00	—$ 90,000.00
3rd year—1935 (steady market)	—$165,000.00	.....
4th year—1936 (steady market)	—$132,000.00	+$ 33,000.00
5th year—1937 (declining market)	+$ 21,000.00	+$153,000.00
6th year—1938 (steady market)	+$ 31,000.00	+$ 10,000.00
Excess of Profits for six years on *Last-In, First-Out Basis* when compared with profits on *Cost-or-Market Basis*—such excess profit of $31,000.00 on the last-in, first-out basis is represented by the amount by which the inventory at the end of the sixth year on the last-in, first-out basis ($371,000.-00) exceeds the inventory on the cost-or-market basis ($340,000.00)		+$ 31,000.00

7th year—(rising market assumed)....	—$ 81,600.00	—$112,600.00
Understatement of Profits for seven years on *Last-In, First-Out Basis* when compared with profits on *Cost-or-Market Basis*—such understatement of profit of $81,000.00 on the last-in, first-out basis is represented by the amount by which the inventory at the end of the seventh year on the cost-or-market basis ($360,000.00) exceeds the inventory on the last-in, first-out basis ($278,400.00)..		—$ 81,600.00

In connection with Schedule D, it has already been pointed out that the prices used in that schedule approximate conditions which existed in the spot cotton market during the years 1933 to 1938, and it is believed that the quantities of cotton purchased each year and the quantities on hand at the end of each year, as set forth in Schedule D, represent reasonable assumptions, considering the position of the cotton market in each year.

Upon reviewing Schedule D and the tabulation presented above, it may be seen in comparing inventory valuations on the last-in, first-out basis with inventory valuations on the cost-or-market basis at the end of each year, that the fluctuations range from an undervaluation of $165,000, or 34.4 per cent, on a rising market at the end of the second year (when compared to the cost-or-market basis) to an overvaluation of $31,000, or 9.1 per cent, on a steady market at the end of the sixth year.

The Cost-or-Market Basis and the Last-In, First-Out Basis Applied to an Actual Case

While hypothetical examples are of considerable value in illustrating the different results attained in applying a principle or basis under varying assumed conditions, frequently the application of such principle to a specific case may prove much more illuminating. Therefore, additional schedules (E and F) are included showing the actual inventories, actual cost of materials consumed, and actual profits and losses on the cost-or-market basis, of a cotton mill for the six years from 1933 to 1938, inclusive, compared with the inventories, cost of materials consumed, and profits and losses for the same six years, on the last-in, first-out

basis, assuming that such basis had been adopted by the company as at December 31, 1932. To facilitate the reading of the schedules, actual quantities of inventories and purchases are shown in round figures and prices of cotton have been carried only to mills. Actual profits on the cost-or-market basis have been revised to give effect to those adjustments in inventory quantities and prices. Such adjustments have not distorted the actual annual figures, because the adjustments resulted in changing the actual profits by less than $12,000 for the entire six years and in changing the actual annual figures of any of the six years by less than that amount. The company adopted as an illustration in Schedules E and F uses both domestic and foreign cotton. It manufactures a product not affected by style changes, and the market price of its product closely follows the market price of raw cotton.

In Schedule E a statement is presented showing inventories and cost of materials consumed, on the cost-or-market basis, for the six years 1933 to 1938, inclusive, based, as previously mentioned, upon an actual case in the cotton industry, compared with inventories and cost of materials consumed, using the last-in, first-out basis.

Below a tabulation is presented (compiled from Schedule E) showing, for each of the six years under review, the inventory quantities at the end of each year, the average inventory prices at the end of each year on both the cost-or-market basis and the last-in, first-out basis, the average purchase price of cotton during each year, and the average prices of cotton consumed each year on both bases:

Years	Inventory Quantities at end of each year (lbs.)	Average Inventory Prices at end of year		Average purchase price of cotton during year	Average prices of cotton consumed during year	
		Cost-or-Market Basis	Last-In, First-Out Basis		Cost-or-Market Basis	Last-In, First-Out Basis
1932	3,000,000	$0.119	$0.119	$.	$.	$.
1933	3,400,000	.162	.120	.169	.134	.175
1934	3,200,000	.199	.120	.184	.147	.180
1935	3,600,000	.190	.128	.212	.222	.214
1936	2,800,000	.190	.128	.193	.192	.182
1937	3,900,000	.161	.146	.204	.231	.207
1938	3,400,000	.165	.146	.178	.172	.170

Although it is clear, on the one hand, from the foregoing tabulation that, in accordance with one of the advantages claimed for the last-in, first-out basis, average prices of material consumed on that basis do follow the average purchase prices more closely than do the average prices of cotton consumed on the cost-or-market basis; yet, on the other hand it, would appear from Schedule E that this result has been accomplished only by substantially undervaluing the inventories in certain years, such undervaluation amounting to $252,800 at December 31, 1934, or almost 40 per cent of the inventory on the cost-or-market basis.

From the foregoing tabulation it may be seen also that the fluctuations in the quantities of the inventories have not been abnormal from year to year, except perhaps at the end of 1937, when the inventory quantity exceeded the quantity at the end of 1932 (the assumed date of adoption of the last-in, first-out basis) by 30 per cent.

After a further study of the foregoing tabulation, the following observations may be drawn therefrom in respect of the last-in, first-out basis:

1. That even if quantities of inventories at the end of subsequent years decline when compared with quantities at December 31, 1938, the inventory prices in subsequent years cannot be reduced below inventory prices at December 31, 1938, even on a declining market, unless during some succeeding year quantities at the end of such year substantially increase and purchase prices decline below December 31, 1938 inventory price.
2. That in order to again reach the low inventory price of December 31, 1932, quantities of inventories in one or more subsequent years must be substantially increased above quantities at December 31, 1938, at prices below the December 31, 1932 price.

The value of the annual inventories and the cost of material consumed on the two bases, for the six years are summarized below from Schedule E:

Year ending Dec. 31	Inventory Value at end of year: Cost-or-Market Basis	Inventory Value at end of year: Last-In, First-Out Basis	Inventory at end of Year on Last-In, First-Out, basis over (+) or under (—) Inventory on Cost-or-Market Basis	Increase (+) or Decrease (—) in Material Consumed for the Year on the Last-In, First-Out Basis when compared with the Cost-or-Market Value
1933	$550,800	$409,000	—$141,800	+$141,800
1934	636,800	384,000	— 252,800	+ 111,000
1935	684,000	460,000	— 224,000	— 28,800
1936	532,000	358,400	— 173,600	— 50,400
1937	627,900	567,400	— 60,500	— 113,100
1938	561,000	496,400	— 64,600	+ 4,100
Total for Six Years				+$ 64,600

From the foregoing tabulation it may be seen that if the last-in, first-out basis had been adopted by the company at the end of 1932, its profits for the two years ending December 31, 1934, would have reduced by $252,800, the amount of the difference between the inventory values at December 31, 1934 on the two bases. It would seem that such a large reduction in profits would naturally be questioned by management, especially since the cotton market had been steadily rising during the two years, and the inventory at December 31, 1934, on the last-in, first-out basis represented an undervaluation of almost 40 per cent when compared with the valuation on the cost-or-market basis.

In Schedule F is presented a statement showing, for the six years ending December 31, 1938, actual profits and losses (before Federal income taxes), on the cost-or-market basis, and profits and losses (before Federal income taxes) on the last-in, first-out basis. Upon reference to that schedule it may be seen that although the total profits on the last-in, first-out basis for the entire six years ($167,500) are only $64,600 less than on the cost-or-market basis ($232,100), surely it hardly can be claimed that in this particular case, at least, the operating results reflect more stability on the last-in, first-out basis than on the cost-or-market basis. On the cost-or-market basis, four years of profits and two years of losses are shown, while on the last-in, first-out basis there are only two years of profits and four years of losses. In the case of the first two years (1933 and 1934), two years of rising prices, the comparative operating results as shown by the two bases are indeed startling, for on the cost-or-market basis profits of $138,400

are shown for the two years, while on the last-in, first-out basis losses of $114,400 are shown for the two years, or a difference of $252,800, such difference representing the amount by which the inventory at December 31, 1934, is understated on the last-in, first-out basis, when compared with the inventory on the cost-or-market basis.

On page 13, a chart is presented which shows more clearly than can be shown in any tabulation, the effect upon the company's surplus account during the six years under review, if the last-in, first-out basis had been used by the company instead of the cost-or-market basis in determining profits during those years.

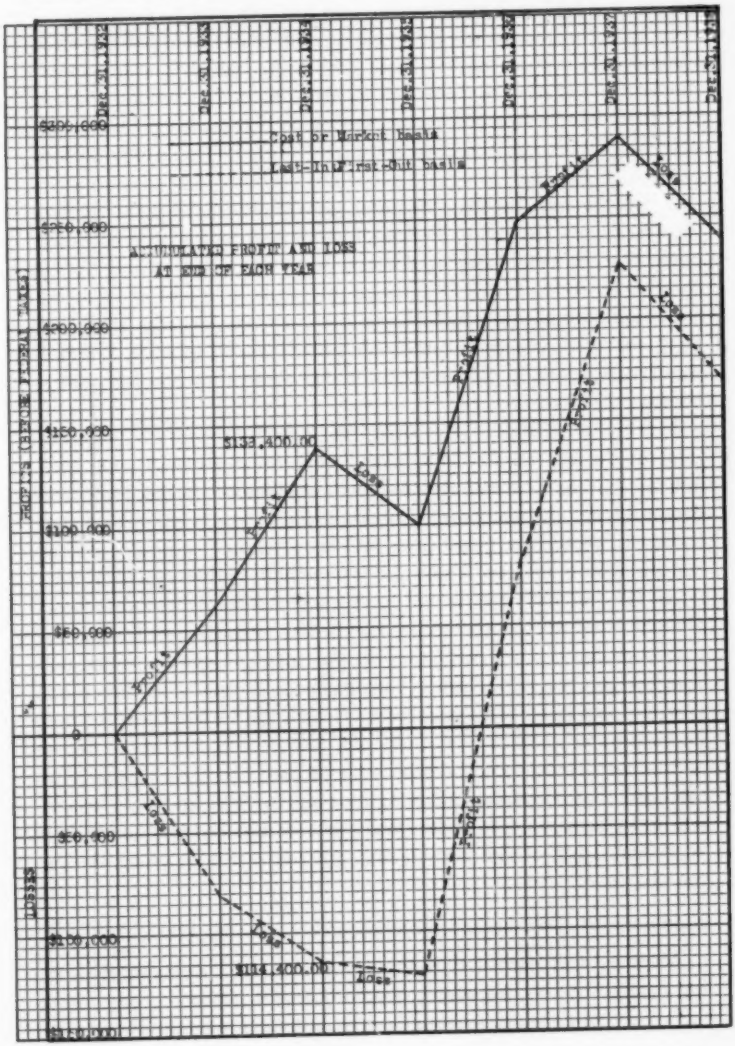
It may be interesting to observe, also, in the case of this same company, the effect of the last-in, first-out basis upon the ratios of current assets to current liabilities at the end of each of the six years under review, when compared with similar ratios on a cost-or-market basis.

RATIOS OF CURRENT ASSETS TO CURRENT LIABILITIES

	Cost-or-Market Basis	Last-In, First-Out Basis
December 31, 1933	6.3 to 1	5.6 to 1
December 31, 1934	5. to 1	3.9 to 1.
December 31, 1935	3.2 to 1	2.6 to 1
December 31, 1936	4.9 to 1	3.9 to 1
December 31, 1937	4. to 1	3.4 to 1
December 31, 1938	4.2 to 1	3.6 to 1

Although the aggregate profits for the six years on the last-in, first-out basis amount to only $167,500 as compared with profits of $232,100 on the cost-or-market basis, yet on the last-in, first-out basis profits of $352,350 would have been subject to Federal income taxes, while on the cost-or-market basis profits of only $327,200 were actually subjected to income tax. The Federal income tax rate was not uniform during the entire six years, and during two years (1936-1937) a heavy penal tax on net income not disbursed as dividends was levied in addition to a graduated income tax. Consequently, if the last-in, first-out basis had been adopted at January 1, 1933, by the company used as an example herein, that company would have shown, on the one hand, $64,600 less profit for the six years 1933-1938, inclusive, than was actually shown on the cost-or-market basis, and on the other hand, it would have been obliged to pay $22,600 more in Federal income and

CUMULATIVE PROFITS (BEFORE FEDERAL TAXES) AND LOSSES - 1933 TO 1938, INCLUSIVE



undistributed profits taxes during those years than it actually did pay on the cost-or-market basis.

In the two tabulations on page 15 there are presented for each year, on the cost-or-market basis and on the last-in, first-out basis, the profits before Federal taxes or the losses, the Federal income and undistributed profits taxes payable on profits, the profits available for dividends, the dividends paid and the net profit or loss carried to surplus.

From the first of the foregoing tabulations it will be seen that the company paid out in Federal income and undistributed profits taxes and dividends during the six years 1933 to 1938, inclusive, $54,600 more than it earned. Such payments in excess of earnings were undoubtedly attributable to the fact that during 1936 and 1937 the company paid out as dividends all its earnings during those two years in order to minimize the payments for undistributed profits taxes.

From the second of the foregoing tabulations it may be seen that on the last-in, first-out basis, the company would have paid out in Federal income and undistributed profits taxes and dividends during the six years, $141,800 more than it earned on that basis. It should be noted, as previously pointed out, that on the last-in, first-out basis Federal income and undistributed profits taxes for the six years would have exceeded by $22,600 the taxes actually paid on the cost-or-market basis, even though the aggregate earnings for the six years on the former basis were $64,600 less than on the latter basis. Furthermore, it should be noted that it would not have been possible to reduce the Federal income and undistributed profits taxes under the last-in, first-out basis, unless additional dividends were paid in 1936 and 1937, or unless it be assumed that the dividends actually paid in 1934 and 1935 would not have been paid in those years but would have been paid in 1936 and 1937, if the last-in, first-out basis was in effect during the six years.

Summary of Conclusions Regarding the Last-In, First-Out Basis

After a careful review of the last-in, first-out basis, the following conclusions as to that basis are presented below:

1. In order to prove effective, either from a purely administrative viewpoint or from a tax viewpoint, it is

Cost-or-Market Basis (as Actually Shown by Company's Books):

Year	Profit (+) or Loss (—) before Federal Income and Undistributed Profits Taxes	Deduct: Federal Income and Undistributed Profits Taxes	Net Profit (+) after taxes, available for dividends, or Net Loss (—)	Deduct: Dividends Paid	Net Profit (+) or Loss (—) transferred to surplus
1933	+$ 60,800.00	$ 8,400.00	+$ 52,400.00	$.	+$ 52,400.00
1934	+ 77,600.00	10,700.00	+ 66,900.00	60,000.00	+ 6,900.00
1935	— 38,200.00	.	— 38,200.00	10,000.00	— 48,200.00
1936	+ 149,500.00	22,800.00	+ 126,700.00	110,000.00	+ 16,700.00
1937	+ 39,300.00	4,800.00	+ 34,500.00	60,000.00	— 25,500.00
1938	— 56,900.00	.	— 56,900.00	.	— 56,900.00
TOTAL	+$232,100.00	$46,700.00	+$185,400.00	$240,000.00	—$ 54,600.00

Last-In, First-Out Basis:

1933	—$ 81,000.00	$.	—$ 81,000.00	$.	—$ 81,000.00
1934	— 33,400.00	.	— 33,400.00	60,000.00	— 93,400.00
1935	— 9,400.00	.	— 9,400.00	10,000.00	— 19,400.00
1936	+ 199,900.00	36,600.00	+ 163,300.00	110,000.00	+ 53,300.00
1937	+ 152,400.00	32,700.00	+ 119,700.00	60,000.00	+ 59,700.00
1938	— 61,000.00	.	— 61,000.00	.	— 61,000.00
TOTAL	+$167,500.00	$69,300.00	+ 98,200.00	$240,000.00	—$141,800.00

essential that the adoption of the basis be made only at a time when the market price of raw materials is at an extremely low point. The adoption of the basis at a time when the market price of raw materials is high might result disastrously from the standpoint of annual operating statements and probably from a tax standpoint also.

2. It must be admitted that during a cycle from one low point in raw material prices extending over a period embracing years of curtailed production, of expansion, of high prices, and back to low prices, the net operating results for the entire cycle should be about the same whether the cost-or-market basis or the last-in, first-out basis is used.
3. During a period of rising prices, inventories on the last-in, first-out basis usually will be below actual cost and below current market price.
4. During a period of declining prices, inventories on the last-in, first-out basis usually will be below actual cost or below current market price, but may be higher, if the quantities fluctuate much from year to year.
5. During a period of rising prices, annual profits will be lower (and losses will be greater) on the last-in, first-out basis than on the cost-or-market basis.
6. During a period of declining prices, annual profits will be higher (and losses will be smaller) on the last-in, first-out basis than on the cost-or-market basis.
7. The complex business activities of any manufacturer from day to day, in judging markets, in building up or reducing inventories, and in manufacturing and selling merchandise, affect all inventory bases, but such activities are conducted, generally, without regard to the inventory basis in use.
8. The building-up and the reduction of quantities of annual inventories over a period of years, combined with the ever-changing conditions of raw material markets, have a decided effect upon the last-in, first-out basis.
9. Concerns which regularly show a profit each year, using the cost-or-market basis, probably will receive more

benefit from the last-in, first-out basis than those concerns whose earnings fluctuate greatly from year to year, and show losses one year and profits the following year.

10. Concerns whose operating results show losses in one year and profits in the following year, are not permitted, under present income tax laws, to apply losses against gains of subsequent years, and the use of the last-in, first-out basis may aggravate that situation by increasing the profits of certain years and increasing the losses of other years, with the result that the aggregate amount of profits subject to income taxes over a period of years might be greater than on the cost-or-market basis. On the other hand, just the reverse might happen.
11. Two members of the same industry using different inventory bases may each be able to prove conclusively that his own basis is preferable in his own case.
12. Each concern contemplating the adoption of the last-in, first-out basis should carefully test the effect of the basis upon operating results by applying it to past operating results, and should not be influenced too much by generalities and theory.

SCHEDULE A

COMPARISON BETWEEN INVENTORIES AND COST OF COTTON CONSUMED ON THE COST-OR-MARKET BASIS AND ON THE LAST-IN, FIRST-OUT BASIS, ASSUMING (1) THE SAME QUANTITY OF INVENTORY AT THE BEGINNING AND END OF THE YEAR AND (2) THREE DIFFERENT CONDITIONS OF THE COTTON MARKET DURING THE YEAR, VIZ.: A STEADY COTTON MARKET, A RISING COTTON MARKET, AND A DECLINING COTTON MARKET

	Cost-or-Market Basis			Last-In, First-Out Basis			Inventory on Last-In, First-Out Basis Over (+) or Under (—) Inventory on Cost-or-Market Basis	Increase (+) or Decrease (—) in Profit for Year on Last-In, First-Out Basis When Compared With Cost-or-Market Basis
	Pounds	Price	Amount	Pounds	Price	Amount		
STEADY COTTON MARKET DURING YEAR:								
Inventory at beginning...	4,000,000	$.0600	$240,000.00	4,000,000	$.0600	$240,000.00		
Purchases	8,000,000	.0650	520,000.00	8,000,000	.0650	520,000.00		
	12,000,000	$.0633	$760,000.00	12,000,000	$.0633	$760,000.00		
Inventory at end.....	4,000,000	.0650	260,000.00	4,000,000	.0600	240,000.00	—$ 20,000.00	
Consumption	8,000,000	$.0625	$500,000.00	8,000,000	$.0650	$520,000.00		—$ 20,000.00
RISING COTTON MARKET DURING YEAR:								
Inventory at beginning...	4,000,000	$.0600	$240,000.00	4,000,000	$.0600	$240,000.00		
Purchases	8,000,000	.0900	720,000.00	8,000,000	.0900	720,000.00		
	12,000,000	$.0800	$960,000.00	12,000,000	$.0800	$960,000.00		
Inventory at end.....	4,000,000	.0900	360,000.00	4,000,000	.0600	240,000.00	—$120,000.00	
Consumption	8,000,000	$.0750	$600,000.00	8,000,000	$.0900	$720,000.00		—$120,000.00
DECLINING COTTON MARKET DURING YEAR:								
Inventory at beginning...	4,000,000	$.0600	$240,000.00	4,000,000	$.0600	$240,000.00		
Purchases	8,000,000	.0450	360,000.00	8,000,000	.0450	360,000.00		
	12,000,000	$.0500	$600,000.00	12,000,000	$.0500	$600,000.00		
Inventory at end.....	4,000,000	.0450	180,000.00	4,000,000	.0600	240,000.00	+$ 60,000.00	
Consumption	8,000,000	$.0525	$420,000.00	8,000,000	$.0450	$360,000.00		+$ 60,000.00

SCHEDULE B

COMPARISON BETWEEN INVENTORIES AND COST OF COTTON CONSUMED ON THE COST-OR-MARKET BASIS AND ON THE LAST-IN, FIRST-OUT BASIS, ASSUMING (1) A REDUCTION IN THE QUANTITY OF INVENTORY AT THE END OF THE YEAR WHEN COMPARED WITH THE QUANTITY AT THE BEGINNING OF THE YEAR, AND (2) THREE DIFFERENT CONDITIONS OF THE COTTON MARKET DURING THE YEAR, VIZ.:
A STEADY COTTON MARKET, A RISING COTTON MARKET, AND A DECLINING COTTON MARKET

	Cost-or-Market Basis			Last-In, First-Out Basis			Inventory on Last-In, First-Out Basis Over (+) or Under (—) Inventory on Cost-or-Market Basis	Increase (+) or Decrease (—) in Profit for Year on Last-In, First-Out Basis When Compared With Cost-or-Market Basis
	Pounds	Price	Amount	Pounds	Price	Amount		
STEADY COTTON MARKET DURING YEAR:								
Inventory at beginning...	4,000,000	$.0600	$240,000.00	4,000,000	$.0600	$240,000.00		
Purchases	8,000,000	.0650	520,000.00	8,000,000	.0650	520,000.00		
	12,000,000	$.0633	$760,000.00	12,000,000	$.0633	$760,000.00		
Inventory at end.....	2,000,000	.0650	130,000.00	2,000,000	.0600	120,000.00	—$10,000.00	
Consumption	10,000,000	$.0630	$630,000.00	10,000,000	$.0640	$640,000.00		—$10,000.00
RISING COTTON MARKET DURING YEAR:								
Inventory at beginning...	4,000,000	$.0600	$240,000.00	4,000,000	$.0600	$240,000.00		
Purchases	8,000,000	.0900	720,000.00	8,000,000	.0900	720,000.00		
	12,000,000	$.0800	$960,000.00	12,000,000	$.0800	$960,000.00		
Inventory at end.....	2,000,000	.0900	180,000.00	2,000,000	.0600	120,000.00	—$60,000.00	
Consumption	10,000,000	$.0780	$780,000.00	10,000,000	$.0840	$840,000.00		—$60,000.00
DECLINING COTTON MARKET DURING YEAR:								
Inventory at beginning...	4,000,000	$.0600	$240,000.00	4,000,000	$.0600	$240,000.00		
Purchases	8,000,000	.0450	360,000.00	8,000,000	.0450	360,000.00		
	12,000,000	$.0500	$600,000.00	12,000,000	$.0500	$600,000.00		
Inventory at end.....	2,000,000	.0450	90,000.00	2,000,000	.0600	120,000.00	+$30,000.00	
Consumption	10,000,000	$.0510	$510,000.00	10,000,000	$.0480	$480,000.00		+$30,000.00

Schedule C

Comparison Between Inventories and Cost of Cotton Consumed on the Cost-or-Market Basis and on the Last-in, First-Out Basis, Assuming (1) an Increase in the Quantity of Inventory at the End of the Year When Compared with the Quantity at the Beginning of the Year, and (2) Three Different Conditions of the Cotton Market During the Year, viz.: A Steady Cotton Market, a Rising Cotton Market, and a Declining Cotton Market

	Cost-or-Market Basis			Last-In, First-Out Basis			Inventory on Last-In, First-Out Basis Over (+) or Under (—) Inventory on Cost-or-Market Basis	Increase (+) or Decrease (—) in Profit for Year on Last-In, First-Out Basis When Compared With Cost-or-Market Basis
	Pounds	Price	Amount	Pounds	Price	Amount		
Steady Cotton Market During Year:								
Inventory at beginning...	4,000,000	$.0600	$240,000.00	4,000,000	$.0600	$240,000.00		
Purchases	8,000,000	.0650	520,000.00	8,000,000	.0650	520,000.00		
	12,000,000	$.0633	$760,000.00	12,000,000	$.0633	$760,000.00		
Inventory at end:								
Inventory from beginning of year.....	—	$.	$.	4,000,000	$.0600	$240,000.00		
Inventory from purchases	6,000,000	.0650	390,000.00	2,000,000	.0650	130,000.00		
Total	6,000,000	$.0650	$390,000.00	6,000,000	$.0617	$370,000.00	—$ 20,000.00	
Consumption	6,000,000	$.0617	$370,000.00	6,000,000	$.0650	$390,000.00		—$ 20,000.00

Rising Cotton Market During Year:								
Inventory at beginning...	4,000,000	$.0600	$240,000.00	4,000,000	$.0600	$240,000.00		
Purchases	8,000,000	.0900	720,000.00	8,000,000	.0900	720,000.00		
	12,000,000	$.0800	$960,000.00	12,000,000	$.0800	$960,000.00		
Inventory at end:								
Inventory from beginning of year.....	—	$.	$.	4,000,000	$.0600	$240,000.00		
Inventory from purchases	6,000,000	.0900	540,000.00	2,000,000	.0900	180,000.00		
Total	6,000,000	$.0900	$540,000.00	6,000,000	$.0700	$420,000.00	—$120,000.00	
Consumption	6,000,000	$.0700	$420,000.00	6,000,000	$.0900	$540,000.00		—$120,000.00
Declining Cotton Market During Year:								
Inventory at beginning...	4,000,000	$.0600	$240,000.00	4,000,000	$.0600	$240,000.00		
Purchases	8,000,000	.0450	360,000.00	8,000,000	.0450	360,000.00		
	12,000,000	$.0500	$600,000.00	12,000,000	$.0500	$600,000.00		
Inventory at end:								
Inventory from beginning of year.....	—	$.	$.	4,000,000	$.0600	$240,000.00		
Inventory from purchases	6,000,000	.0450	270,000.00	2,000,000	.0450	90,000.00		
Total	6,000,000	$.0450	$270,000.00	6,000,000	$.0550	$330,000.00	+$ 60,000.00	
Consumption	6,000,000	$.0550	$330,000.00	6,000,000	$.0450	$270,000.00		+$ 60,000.00

Schedule D

Comparison Between Inventories and Cost of Cotton Consumed During a Period of Seven Years on the Cost-or-Market-Whichever-Lower Basis, and on the Last-In, First-Out Basis, Assuming Hypothetical Quantities of Cotton on Hand at Beginning and End of Each Year and Hypothetical Purchases of Cotton, but Following as to Cotton Prices for the First Six Years the Approximate Conditions which Existed in the Spot Cotton Market During the Years 1933 to 1938, Inclusive

	Cost-or-Market Basis			Last-In, First-Out Basis			Inventory on Last-In, First-Out Basis Over (+) or Under (—) Inventory on Cost-or-Market Basis	Increase (+) or Decrease (—) in Profit for Year on Last-In, First-Out Basis When Compared with Cost-or-Market Basis
	Pounds	Price	Amount	Pounds	Price	Amount		
1st Year:—1933								
Inventory at beginning...	4,000,000	$.0650	$ 260,000.00	4,000,000	$.0650	$ 260,000.00		
Purchases	8,000,000	.0900	720,000.00	8,000,000	.0900	720,000.00		
	12,000,000	$.0817	$ 980,000.00	12,000,000	$.0817	$ 980,000.00		
Inventory at end.....	3,000,000	$.0900	$ 270,000.00	3,000,000	.0650	195,000.00	—$ 75,000.00	
Consumption	9,000,000	$.0789	$ 710,000.00	9,000,000	$.0872	$ 785,000.00		—$ 75,000.00
2nd Year:—1934								
Inventory at beginning...	3,000,000	$.0900	$ 270,000.00	3,000,000	$.0650	$ 195,000.00		
Purchases	8,000,000	.1200	960,000.00	8,000,000	.1200	960,000.00		
	11,000,000	$.1118	$1,230,000.00	11,000,000	$.1050	$1,155,000.00		
Inventory at end.....	4,000,000	.1200	480,000.00	4,000,000	.0788	315,000.00	—$165,000.00	
Consumption	7,000,000	$.1071	$ 750,000.00	7,000,000	$.1200	$ 840,000.00		—$ 90,000.00
3rd Year:—1935								
Inventory at beginning...	4,000,000	$.1200	$ 480,000.00	4,000,000	$.0788	$ 315,000.00		
Purchases	9,000,000	.1200	1,080,000.00	9,000,000	.1200	1,080,000.00		
	13,000,000	$.1200	$1,560,000.00	13,000,000	$.1073	$1,395,000.00		
Inventory at end.....	5,000,000	.1200	600,000.00	5,000,000	.0870	435,000.00	—$165,000.00	
Consumption	8,000,000	$.1200	$ 960,000.00	8,000,000	$.1200	$ 960,000.00		$.....

4th Year:—1936								
Inventory at beginning...	5,000,000	$.1200	$ 600,000.00	5,000,000	$.0870	$ 435,000.00		
Purchases	6,000,000	.1200	720,000.00	6,000,000	.1200	720,000.00		
	11,000,000	$.1200	$1,320,000.00	11,000,000	$.1050	$1,155,000.00		
Inventory at end.....	4,000,000	.1200	480,000.00	4,000,000	.0870	348,000.00	—$132,000.00	
Consumption	7,000,000	$.1200	$ 840,000.00	7,000,000	$.1153	$ 807,000.00		+$ 33,000.00
5th Year:—1937								
Inventory at beginning...	4,000,000	$.1200	$ 480,000.00	4,000,000	$.0870	$ 348,000.00		
Purchases	7,000,000	.1150	805,000.00	7,000,000	.1150	805,000.00		
	11,000,000	$.1168	$1,285,000.00	11,000,000	$.1048	$1,153,000.00		
Inventory at end.....	3,000,000	.0800	240,000.00	3,000,000	.0870	261,000.00	+$ 21,000.00	
Consumption	8,000,000	$.1306	$1,045,000.00	8,000,000	$.1115	$ 892,000.00		+$153,000.00
6th Year:—1938								
Inventory at beginning...	3,000,000	$.0800	$ 240,000.00	3,000,000	$.0870	$ 261,000.00		
Purchases	6,000,000	.1100	660,000.00	6,000,000	.1100	660,000.00		
	9,000,000	$.1000	$ 900,000.00	9,000,000	$.1023	$ 921,000.00		
Inventory at end.....	4,000,000	.0850	340,000.00	4,000,000	.0928	371,000.00	+$ 31,000.00	
Consumption	5,000,000	$.1120	$ 560,000.00	5,000,000	$.1100	$ 550,000.00		+$ 10,000.00
Excess of Profits for six years on *Last-In, First-Out Basis* when compared *with Profits on Cost-or-Market-Whichever-Lower Basis*—such excess profit of $31,000.00 on Last-In, First-Out Basis is represented by the amount by which the inventory at the end of the sixth year on the Last-In, First-Out Basis ($371,000.00) exceeds the inventory on the Cost-or-Market Basis $340,000.00).							+$ 31,000.00	
7th Year:								
Inventory at beginning...	4,000,000	$.0850	$ 340,000.00	4,000,000	$.0928	$ 371,000.00		
Purchases	5,000,000	.1200	600,000.00	5,000,000	.1200	600,000.00		
	9,000,000	$.1044	$ 940,000.00	9,000,000	$.1078	$ 971,000.00		
Inventory at end.....	3,000,000	.1200	360,000.00	3,000,000	.0928	278,400.00	—$ 81,600.00	
Consumption	6,000,000	$.0967	$ 580,000.00	6,000,000	$.1153	$ 692,600.00		—$112,600.00
Excess of Profits for seven years on *Cost-or-Market-Whichever-Lower Basis* when compared with Profits on *Last-In, First-Out Basis*—such excess profit of $81,600.00 on Cost-or-Market Basis is represented by the amount by which the inventory at the end of the seventh year on the Cost-or-Market Basis ($360,000.00) exceeds the inventory on the Last-In, First-Out Basis ($278,400.00).								—$ 81,600.00

Schedule E

Statement Showing Inventories and Cost of Materials Consumed on the Cost-or-Market Basis for the Six Years 1933 to 1938, Inclusive, Based upon an Actual Case in the Cotton Industry, Compared with Inventories and Cost of Materials Consumed Using the Last-in First-Out Basis in the Same Case

	Cost-or-Market Basis			Last-In, First-Out Basis			Inventory at end of Year on Last-In, First-Out Basis Over (+) or Under (—) Inventory on Cost-or-Market Basis	Increase (+) or Decrease (—) in Materials Consumed for Year on Last-In, First-Out Basis when Compared with Pounds on Cost-or-Market Basis
1933	Pounds	Average Price	Amount	Pounds	Average Price	Amount		
Inventory—Beginning	3,000,000	$.119	$ 357,000.00	3,000,000	$.119	$ 357,000.00		
Purchases	4,000,000	.169	676,000.00	4,000,000	.169	676,000.00		
	7,000,000	$.146	$1,033,000.00	7,000,000	$.146	$1,033,000.00		
Inventory—End:								
From beginning of year	.....	....	.....	3,000,000	$.119	$ 357,000.00		
From earliest purchases	.....	....	.....	400,000	.130	52,000.00		
	3,400,000	$.162*	$ 550,800.00	3,400,000	$.120	$ 409,000.00	—$141,800.00	
Consumption	3,600,000	$.134	482,200.00	3,600,000	$.175	$ 624,000.00		+$141,800.00
1934								
Inventory—Beginning	3,400,000	$.162	$ 550,800.00	3,400,000	$.120	$ 409,000.00		
Purchases	3,100,000	.184	570,400.00	3,100,000	.184	570,400.00		
	6,500,000	$.173	$1,121,200.00	6,500,000	$.151	$ 979,400.00		
Inventory—End:								
From beginning of year	.....	....	.....	3,200,000	$.120	$ 384,000.00		
From earliest purchases	.....	....	.....	—	—	—		
	3,200,000	$.199*	$ 636,800.00	3,200,000	$.120	$ 384,000.00	—$252,800.00	
Consumption	3,300,000	$.147	$ 484,400.00	3,300,000	$.180	$ 595,400.00		+$111,000.00
1935								
Inventory—Beginning	3,200,000	$.199	$ 636,800.00	3,200,000	$.120	$ 384,000.00		
Purchases	4,200,000	.212	890,400.00	4,200,000	.212	890,400.00		
	7,400,000	$.206	$1,527,200.00	7,400,000	$.172	$1,274,400.00		

	7,400,000	$.206	$1,527,200.00	7,400,000	$.172	$1,274,400.00		
Inventory—End:								
From beginning of year..	.....	....	.....	3,200,000	$.120	$ 384,000.00		
From earliest purchases..	.....	....	.....	400,000	.190	76,000.00		
	3,600,000	$.190*	$ 684,000.00	3,600,000	$.128	$ 460,000.00	—$224,000.00	
Consumption	3,800,000	$.222	$ 843,200.00	3,800,000	$.214	$ 814,400.00		—$ 28,800.00
1936								
Inventory—Beginning	3,600,000	$.190	$ 684,000.00	3,600,000	$.128	$ 460,000.00		
Purchases	3,900,000	.193	752,700.00	3,900,000	.193	752,700.00		
	7,500,000	$.192	$1,436,700.00	7,500,000	$.162	$1,212,700.00		
Inventory—End:								
From beginning of year..	.....	....	.....	2,800,000	$.128	$ 358,400.00		
From earliest purchases..	.....	....	.....	—	.	.		
	2,800,000	$.190*	$ 532,000.00	2,800,000	$.128	$ 358,400.00	—$173,600.00	
Consumption	4,700,000	$.192	$ 904,700.00	4,700,000	$.182	$ 854,300.00		—$ 50,400.00
1937								
Inventory—Beginning	2,800,000	$.190	$ 532,000.00	2,800,000	$.128	$ 358,400.00		
Purchases	5,900,000	.204	1,203,600.00	5,900,000	.204	1,203,600.00		
	8,700,000	$.199	$1,735,600.00	8,700,000	$.180	$1,562,000.00		
Inventory—End:								
From beginning of year..	.....	....	.....	2,800,000	$.128	$ 358,400.00		
From earliest purchases..	.....	....	.....	1,100,000	.190	209,000.00		
	3,900,000	$.161*	$ 627,900.00	3,900,000	$.146	$ 567,400.00	—$ 60,500.00	
Consumption	4,800,000	$.231	$1,107,700.00	4,800,000	$.207	$ 994,600.00		—$113,100.00
1938								
Inventory—Beginning	3,900,000	$.161	$ 627,900.00	3,900,000	$.146	$ 567,400.00		
Purchases	3,100,000	.178	551,800.00	3,100,000	.178	551,800.00		
	7,000,000	$.169	$1,179,700.00	7,000,000	$.160	$1,119,200.00		
Inventory—End:								
From beginning of year..	.....	....	.....	3,400,000	$.146	$ 496,400.00		
From earliest purchases..	.....	....	.....	—	.	.		
	3,400,000	$.165*	$ 561,000.00	3,400,000	$.146	$ 496,400.00	—$ 64,600.00	
Consumption	3,600,000	$.172	$ 618,700.00	3,600,000	$.170	$ 622,800.00		+$ 4,100.00
								+$ 64,600.00

Increase in materials consumed (and decrease in profits) for the six years 1933 to 1938, inclusive, on the last-in, first-out basis when compared with the cost-or-market basis.

* Prices represent averages of inventories taken on cost-or-market basis *applied to each lot of cotton on hand.*

SCHEDULE F

STATEMENT SHOWING ACTUAL PROFITS AND LOSSES (BEFORE FEDERAL INCOME TAXES) ON COST-OR-MARKET BASIS, FOR THE SIX YEARS ENDING DECEMBER 31, 1938, AND PROFITS AND LOSSES (BEFORE FEDERAL INCOME TAXES) ON LAST-IN, FIRST-OUT BASIS

Year Ending December 31	Profits (+) or Losses (—) (Before Federal Income Taxes) on Cost-or-Market Basis	Increase (+) or Decrease (—) in Cost of Material Consumed on Last-In, First-Out Basis When Compared With Cost-or-Market Basis	Profits (+) or Losses (—) on Last-In, First-Out Basis (Before Federal Income Taxes)
1933	+$ 60,800.00	+$141,800.00	—$ 81,000.00
1934	+ 77,600.00	+ 111,000.00	— 33,400.00
1935	— 38,200.00	— 28,800.00	— 9,400.00
1936	+ 149,500.00	— 50,400.00	+ 199,900.00
1937	+ 39,300.00	— 113,100.00	+ 152,400.00
1938	— 56,900.00	+ 4,100.00	— 61,000.00
Total	+$232,100.00	+$ 64,600.00	+$167,500.00
Total Profits—Profit Years (Four Years)	+$327,200.00	(Two Years)	+$352,300.00
Total Losses—Loss Years (Two Years)	—$ 95,100.00	(Four Years)	—$184,800.00